Buy Sell Planning – Part 4: Valuation Methods and Purchase Price

One of the trickiest details of a good Buy-Sell Agreement is determining the purchase price to be paid for a departing owner's interest in the business. Most Buy-Sell Agreements create a formula to estimate the business's actual "fair market value" and then derive a purchase price for an owner's pro-rata share of the business. Sometimes the Buy-Sell Agreement requires the business to be appraised by an independent qualified appraiser with special certifications. Whether there is a formula in the agreement or an appraiser will be involved, the goal is identifying "fair market value" of the business and the interest to be transferred. "Fair market value" is often defined as the price that would be paid between willing and independent buyers and sellers, assuming neither is being forced to buy or sell and both have good knowledge of the facts. If a minority owner's interest is being acquired or there are restrictions on subsequent transfers of an ownership interest (e.g. in a shareholders agreement), then "discounts" may be applied to the fair market value for the lack of control or lack of marketability. Some common business valuation methods are outlined below, but there is no magic formula that fits all cases.

Book Value. The Book Value method is based on the net worth (i.e. assets -- liabilities) of a business. While this method is easy and relatively inexpensive, it uses historical values in the calculation. These original values may not provide an accurate picture of the current value at the time of a triggering event. Modifications to the book value method can be made to enhance the reasonableness of the valuation by getting updated values for certain assets.

Discounted Cash Flow (DCF). The DCF method values the business based on the "present value" of the projected net cash flow of the business over a future period of time. Adjustments should be made for certain noncash expenses (e.g. depreciation, amortization), and allocations are often made for reasonable future capital expenses to allow the company to continue growing (e.g., equipment replacement). Some business owners have difficulty with this method because of all of the variables involved and the assumptions made about future performance.

Multiples of Sales or Operating Profit. The method of using a "multiple" of sales or operating profit is similar to the DCF method above, but, instead of making assumptions about future returns, the valuation starts from actual past results to calculate a value of the business (of course, this still presumes that the business will continue to perform at least as well as in the past.) Using a multiple is common for service businesses where tangible assets are not a reasonable gauge of the business' value. The multipliers used are often industry specific and can vary based on geography or the current economy. The main problem with using industry multiples is adjusting for company-specific values and differentiators.

"Shootout" Provision – This business ain't big enough for the both of us… A good Buy-Sell Agreement should have a solution for when an impasse is reached between business partners and one of you must leave. This situation is often ignored by owners who don't want to consider this ugly possibility, but having a framework in place can make that ugly possibility a little easier to handle. One solution is a Shootout provision (aka "put-call option"). This provision allows a dissatisfied owner to "put an offer on the table" at a certain price per ownership unit of the company. Then there is a time period (e.g. 30 days) when the other owners have the option to either (i) buy the dissatisfied owner's interest or (ii) sell their ownership interest to the dissatisfied owner at the stated price. Beware the rash decision to put an offer on the table if you do not have a very clear idea of the reasonable value of the company! Don't assume your partner's will buy you out (they might sell…), and don't assume the price paid to an owner 12 months ago is still an appropriate price.

Stipulated Value. What if you just don't have any clue? Some business owners meet periodically (e.g. every 12 – 18 months) and stipulate a value for the business to be used in the Buy-Sell Agreement until the next meeting. If you plan to go this route, make sure to involve your tax, legal, and insurance advisors, and make sure the value is realistic in case a triggering event does occur. If you have insurance policies in place to fund a buyout after an owner's death, make sure your stipulated value and insurance coverage are always in line!

Regardless of how you derive the value of the business and the price to be paid for a departing owner's interest, the value and the price must be fair and reasonable to all involved. When a triggering event occurs, everyone should be fully comfortable and prepared to move forward with the plan.